United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-7178

United States Court of Appeals
FOR THE SECOND CIRCUIT

B

Docket No. 76-7178

P/S

FRANKLIN SAVINGS BANK OF NEW YORK,
Plaintiff-Appellee,

—against—

GUSTAVE L. LEVY, *et al.*,
Defendants-Appellants.

BRIEF FOR APPELLANTS

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Preliminary Statement

Appellants Goldman, Sachs & Co. and its general partners ("Goldman, Sachs") appeal from a judgment in favor of Franklin Savings Bank of New York ("Franklin") entered by the District Court for the Southern District of New York (Honorable Charles M. Metzner) after trial to the Court without a jury in this action brought under the federal Securities Acts. The opinion of the District Court is reported at 406 F. Supp. 40 (S.D.N.Y. 1975) (1453a).

Goldman, Sachs challenges the subject matter jurisdiction of the court under both the Securities Exchange Act of 1934 ("1934 Act") and the Securities Act of 1933 ("1933 Act"). In addition to jurisdiction, the principal issues on appeal concerns the District Court's holding of liability without finding that Goldman, Sachs acted with an intent to deceive, manipulate or defraud, without permitting Goldman,

Sachs to introduce all relevant evidence on the question of its own mental state, and on the basis of certain findings of the trial court which are clearly erroneous.

The Questions Presented for Review

1. Did the District Court err in concluding that the commercial paper note sold to Franklin, which had a maturity at the time of issuance of less than nine months, was a "security" as defined in § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10)?

2. Did the District Court err in concluding that two mailings made after the sale of commercial paper to Franklin, from Franklin's agent bank and from Goldman, Sachs, neither of which constituted an offer or sale of the commercial paper, were nevertheless sufficient to meet the jurisdictional element of a claim under § 12(2) of the 1933 Act, 15 U.S.C. § 77l(2)?

3. Does the record evidence support any conclusion by the District Court which could be interpreted as finding that Goldman, Sachs intended to deceive or defraud Franklin, as required by *Ernst & Ernst* v. *Hochfelder*, 96 S. Ct. 1375 (1976)?

4. If the District Court purported to base its conclusion of liability on the requisite finding of *scienter*, did it commit reversible error in excluding proffered testimony demonstrating Goldman, Sachs' good faith?

5. Should the test of "materiality" for purposes of § 12(2) of the 1933 Act and § 10(b) of the 1934 Act be as articulated in *TSC Industries, Inc.* v. *Northway, Inc.*, 96 S. Ct. 2126 (1976)?

6. Where the only statement made by Goldman, Sachs was the implied expression of its good faith opinion, did

the District Court err in finding liability under § 12(2) without necessarily finding that the opinion was not honestly held?

Statement of the Case

A. The Nature of the Case

On March 16, 1970, Franklin bought from Goldman, Sachs, as dealer, a commercial paper note of Penn Central Transportation Company ("Penn Central") in the principal amount of $500,000 for a net price of $487,958.33. The note bore a maturity date of June 26, 1970, or slightly over 3 months; the borrower, Penn Central, filed for reorganization under § 77 of the Bankruptcy Act on June 21, 1970, and Franklin's note was not paid upon maturity.

On March 1, 1971, Franklin commenced an action against Goldman, Sachs alleging, *inter alia*, violations of § 12(2) of the 1933 Act,* § 10(b) of the 1934 Act** and SEC Rule 10b-5 promulgated thereunder.***

Trial before Judge Metzner began on June 2, 1975 and lasted nine days. On December 29, 1975, the District Court filed a decision which appears to hold that Goldman, Sachs violated § 10(b) by failing to disclose two material facts to plaintiff, and that it violated § 12(2) by misrepresenting the implied basis upon which it was selling commercial paper. On January 13, 1976, judgment was entered in favor of plaintiff.

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* 15 U.S.C. § 77l(2).

** 15 U.S.C. § 78j(b).

*** 17 C.F.R. 240.10b-5. Plaintiff also alleged claims for relief under New York's Martin Act, N.Y. Gen. Bus. L. § 352-c, and the common law. These claims were dismissed by the District Court, 406 F. Supp. at 47 (1460a), and plaintiff has not appealed from that ruling.

Goldman, Sachs moved on January 23, 1976 to amend the judgment or, in the alternative, for a new trial on certain issues. On March 6, 1976, the District Court without opinion denied Goldman, Sachs' motion by order entered on March 8, 1976. The notice of appeal was timely filed on April 5, 1976. 28 U.S.C. § 1291; Fed. R. App. P. 4(a).

B. The Facts

Before discussing the events immediate to Franklin's purchase, it is necessary to recount briefly the context in which they occurred. To that end an understanding of the nature of the commercial paper market and Goldman, Sachs' relationship with Penn Central is required. In particular, it is vital that the concept of inventory and the evaluation of Goldman, Sachs' inventory policy be briefly explained. A full understanding of the facts surrounding Goldman, Sachs inventory policy will reveal that the factual conclusion of the trial court is insufficient to impose liability as a matter of law.

* * * *

Commercial paper consists of short-term, unsecured promissory notes of industrial or finance corporations. For over one hundred years the commercial paper market has provided a source of cash to corporations requiring external sources of funds for less cost than bank borrowing, and has simultaneously provided investors having monies on hand with a mode of investment offering a more favorable interest rate than that which could be obtained from comparable money market instruments.

Commercial paper interest rates—favorable to both investors and issuers—are only fractionally different than rates available on certificates of deposit, Treasury bills and other money market instruments. The differential becomes significant in investments averaging thirty to sixty

or ninety days only if the sums involved are very large. In fact, the average commercial paper transaction during 1969 and 1970 involved the sale of a note or notes having an aggregate face amount of over $1 million. In the ordinary course, sales of under $100,000 were prohibited as a matter of Goldman, Sachs' policy. (Van Cleave, Tr. 347a-48a).

Putting aside all else, the mere size of commercial paper transactions substantially limited the type of investors who had the ability to participate in this market.* Only the professional money manager, such as Mr. Bock, President of Franklin (Bock, Tr. 190a), had sufficient money and the requisite sophistication and market skills to invest in commercial paper. (Van Cleave, Tr. 347a-48a, 351a).

Aside from issuers and investors, the remaining participants in the commercial paper market are dealers such as Goldman, Sachs. Dealers buy paper as principal from the issuer at one interest rate in order to sell it as principal to investors at a slightly lower interest rate (*i.e.*, a higher price). This intended "spread" is the dealer's compensation for performing his role.

To be successful in fulfilling the needs of both investors and issuers dealers must be able to buy and sell commercial paper in myriad amounts and maturities. Historically, dealers achieved the flexibility necessary to serve

* That the commercial paper market was a professional one is shown by Exhibit F-93 (CU) (1365a-68a) which lists all of the entities which purchased Penn Central commercial paper—either as an investment for that entity itself or for the account of a usually undisclosed customer. The exhibit shows that banks, mutual funds, pension funds, major industrial corporations and insurance companies account for the vast bulk of all sales. Large banks and mutual funds predominate in terms of total face amount purchased as well as number of transactions. (*See also* Van Cleave, Tr. 348a-49a).

these needs by maintaining an inventory of commercial paper notes of various issuers. Maintenance of such an inventory also permitted dealers to give the investor same-day delivery, which was highly desirable in a market in which the average purchase is $1 million and a single day's interest can be substantial. (Van Cleave, Tr. 394a).

For over one hundred years, following the development of the commercial paper market after the Civil War, the practice of inventorying paper remained unchanged. Finally, however, developments in the market forced a reassessment of inventory operations and a gradual change in actual policy. The change began in the late 1960s when the American economy experienced a tremendous cash shortage. With banks lacking the necessary capital to extend loans and with the price of equity securities at unfavorable lows, thus making equity financing unattractive, America's corporations turned to the commercial paper market for cash. As a result the volume of commercial paper outstanding rose dramatically as did Goldman, Sachs' inventory. (Van Cleave, Tr. 394a-397a).

The efforts of Goldman, Sachs to deal with the problems of excessive inventory and to adapt its business to a new era are at the heart of this lawsuit: The decision of the trial court hinges upon a misinterpretation of one instance of Goldman, Sachs' adaptation to new circumstances—a result made possible only by the exclusion of admissible evidence and reliance upon certain supportive findings which are utterly without record support.

In the fall of 1969 Goldman, Sachs' commercial paper department undertook a study of the efficiency and profitability of the department for the purpose of determining what improvements could be made in commercial paper operations. (Doty, Tr. 580a-81a; Ex. FA, 1414a). Pre-

liminary data were available by the end of 1969 and resulted in a final report to the management committee of Goldman, Sachs in March 1970. (Ex. F-56, 1332a). Although members of the department had previously been aware that there were certain costs attributable to inventory, it was only as a result of the data developed for that study that it became apparent that carrying a large commercial paper inventory was a major reason that the commercial paper department, although profitable, was not a substantial contributor to the profits of the firm as a whole.

Two costs are associated with carrying inventory: "negative carry" costs and "mark-up" costs. During 1969 and 1970, while Goldman, Sachs' inventory was regularly above $200 million, its partnership capital was only $45 million. This meant that, like other dealers, Goldman, Sachs was required to borrow money many times its own worth to purchase paper for its inventory. Although inventory paper earns interest at whatever rate is reflected in the purchase price of the note, Goldman, Sachs lost money on its inventory operation whenever the rate at which Goldman, Sachs was required to borrow exceeded the rate of return on the paper itself. (Doty, Tr. 559a; Ex. CL, 1403a-04a). This cost of carrying inventory was known as negative carry loss.*

Substantial losses also resulted from the necessity of selling paper at a higher discount rate (*i.e.*, lower price) than that at which it was purchased. These "mark-up" losses occurred whenever market rates rose while paper remained unsold in inventory. (Van Cleave, Tr. 399a-401a, 414a).

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* From March 1969 to March 1970, Goldman, Sachs suffered a negative carry loss of nearly one million dollars. (Ex. F-56, at 5, 1340a).

It also became apparent during this period that from a marketing viewpoint commercial paper in inventory sold less freely than so-called "special order" commercial paper.* The sale of special order paper was also simpler and was for that reason preferred by commercial paper salesmen—which contributed to its comparative saleability. (Doty, Tr. 578a-79a; Van Cleave, Tr. 407a-10a; Lepley, Tr. 944a-45a; Ex. BI, Jan. 14, 1970, 1385a).

Despite the recognition that inventory costs and administrative burdens were detrimental to the operation of the commercial paper department, it was not deemed practical to eliminate all commercial paper inventory. Instead, attention focused upon situations where it would be easy to persuade issuers to reduce inventory voluntarily or where reliance upon inventory by an issuer verged upon abuse of the privilege and so required remedy as soon as practicable. (Van Cleave, Tr. 432a-34a). By the winter of 1969-70 Penn Central, the inventory of which had been as high as $30 million on occasion and which was frequently the issuer having the largest single position in Goldman Sachs' total inventory (*see, e.g.*, Ex. F-95, 1369a-79a), clearly fell in the latter category. As indicated hereafter, it was in response to this perceived abuse in the context of rising inventory costs that led to the reduction in inventory that the trial court improperly characterized.

Before turning to Goldman, Sachs' experience in handling its inventory of Penn Central commercial paper, however, the relationship between Goldman, Sachs and the railroad should be outlined.

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* Unlike inventory paper, on which the denomination and maturity were fixed by the issuer, special order paper was usually available from the issuer's releasing bank in New York, and the denomination and maturity could be affixed after the note was sold, thus being tailor-made to the investor's needs.

The Penn Central was formed on February 1, 1968 by the merger of The New York Central and Pennsylvania Railroad. Goldman, Sachs never had a historical investment banking relationship with either predecessor and, according to the chief financial officer of Penn Central, was chosen simply because it would do the best job as a commercial paper dealer. (Bevan Dep. 13).

In May of 1968, Penn Central told Goldman, Sachs that it was about to seek authority from the Interstate Commerce Commission ("I.C.C.") to issue $100 million in commercial paper and proposed to sell the paper through Goldman, Sachs. Immediately afterwards and continuing through June and July of 1968, the Credit Department of Goldman, Sachs' Commercial Paper Department and its head, Jack Vogel, conducted an initial credit review of Penn Central. The conclusion of this credit investigation was that Penn Central was creditworthy and, as a corollary, that there was no credit reason for Goldman, Sachs not to handle its paper. The correctness of the conclusion is not disputed. 406 F. Supp. at 44 (1457a). Penn Central commenced issuing commercial paper as of August 1, 1968 and continued doing so until early May 1970.

During 1969 and 1970, Goldman, Sachs as part of its ongoing credit investigation maintained contact on a regular basis with Penn Central. These contacts by and large were recorded in "blue sheets"—internal Goldman, Sachs memoranda recording meetings with issuers and written to inform other personnel of Goldman, Sachs of those meetings. Plaintiff's arguments and the opinion of the trial court focused attention on the events of early February 1970—particularly those reflected in a blue sheet written by Robert Wilson dated February 6, 1970 (Ex. F-3 (A-69), 1303a). As is apparent from the trial court's opinion,

earlier developments regarding Penn Central are largely irrelevant. 406 F. Supp. at 44 (1457a).

On February 6, 1970, David Bevan, Chairman of the Finance Committee of Penn Central, and Jonathan O'Herron, Vice President-Finance, met with Gustave L. Levy, senior partner of Goldman, Sachs, and Robert G. Wilson, head of the commercial paper department, to discuss the financial prospects and financing plans of Penn Central. This meeting was prompted by the announcement on February 4 that Penn Central had incurred a $56 million railroad operating loss in 1969.

At the February 6 meeting Bevan "did a thorough job of explaining" the $56 million operating loss. (Ex. F-3 (A-69), 1303a). Although this loss was substantial, Wilson did not consider it troublesome when viewed in light of Penn Central's consolidated earnings, its strong asset structure, and management's plans for 1970.

Included in Bevan's explanation of the 1969 year-end results was the management's projections for 1970. Bevan predicted that the railroad would again incur an operating loss of $56 million but that the holding company would report a consolidated profit of $20-25 million in 1970. Both pieces of information had a positive influence on Wilson's assessment of Penn Central's creditworthiness. The $56 million predicted yearly loss for 1970 was actually favorable news because of Penn Central's history of declining earnings. As Wilson testified,

> ". . . Dave Bevan was telling us at this luncheon . . . that the losses in 1970 aren't going to get any worse, they are going to be the same as 1969 in the operating figures of the railroad. So this looked like kind of a plateauing out to me."

(Wilson, Tr. 1107a). Furthermore, the holding company had consolidated income in 1969 of only $4 million, but in February, 1970, Bevan was predicting that consolidated earnings for 1970 would be five to six times as great.

Another subject that arose at the February 6 meeting was the question of whether, and to what extent, Goldman, Sachs should continue to finance Penn Central's inventory, and whether Penn Central would listen to Goldman, Sachs' advice on how to market its paper. This discussion was part of a larger dialogue going back to the fall of 1969 when Goldman, Sachs first became aware of inventory problems generally and in that context noted the steady increase in the size of Penn Central's inventory. (Van Cleave, Tr. 452a-53a; Lepley, Tr. 918a-20a; Exs. F-9, 1308a and F-63, 1348a).

During the fall and early winter O'Herron had been of the view that inventory was Goldman, Sachs' problem—and one for which he had little sympathy. Accordingly, he continued to decline to take the steps which might have alleviated the inventory problem by making Penn Central's paper more saleable. Initially he declined to convert any of Penn Central's bank lines of credit to "swing" lines—a step which would have allowed bank credit to be used as an alternative to inventory on a daily basis.* O'Herron took the position that it was better as far as Penn Central was concerned for Goldman, Sachs to hold the inventory, borrow on it and sustain losses, than it was for Penn

* A "swing" line of credit from a bank may be used on very short notice and may be repaid at the option of the borrower at any time. It can therefore be used day-by-day to smooth out fluctuations in cash flow resulting from changes in commercial paper outstandings. This eliminates the need to inventory paper to meet cash needs and allows the dealer to offer more saleable special order paper rather than stale inventory paper to investors.

Central to obtain swing lines at the cost of compensating balances and the further cost of higher interest payments when such lines were actually in use. (Van Cleave, Tr. 456a-57a).

By repeated complaints, Goldman, Sachs finally persuaded Penn Central to repurchase from Goldman, Sachs' inventory some $16 million of Penn Central paper in late December 1969. There is no suggestion by plaintiff or the trial court, however, that this transaction in December is in any way suspect, although it was exactly the same as the inventory reduction in February 1970. (Lepley, Tr. 931a; Van Cleave, Tr. 457a).

The December reduction proved not to be permanent, however, and by mid-Januay the size of inventory again increased and remained at high levels throughout the month. (Ex. CW, 1405a-10a; Van Cleave, Tr. 458a-59a).

When the Febuary 4 press release provided the opportunity to try again to remedy the situation, Wilson acted immediately. On February 5, Wilson called O'Herron to obtain additional information regarding the significance of the announced results, and during the course of his discussion told O'Herron that because the announcement of an operating loss could result in a slowdown of commercial paper sales and a resultant accumulation of even more paper in inventory, Goldman, Sachs would no longer inventory Penn Central in the amounts previously accepted. The next day in further discussions Wilson set a limit of $5 million. (*See* Exs. F-2 (A-71), 1302a; F-3 (A-69), 1303a).

Wilson imposed that $5 million limitation both to reduce the total cost of carrying Penn Central commercial paper in inventory and because he felt that the announcement gave him the opening to accomplish the long sought goal of forcing Penn Central to reduce its dependence upon in-

ventory and turn instead to swing lines. (Wilson, Tr. 1103a-05a). The history of complaints by Goldman, Sachs and of insufficient response by Penn Central all through the fall and winter confirms that this action was necessary, consistent with past behavior and not caused by developments regarding the financial condition of Penn Central.

The inventory limitation was essentially successful. Swing lines were arranged and used and, as a result, inventory generally remained low and sales improved significantly. At the time of Franklin's purchase Goldman, Sachs' inventory of Penn Central commercial paper—after having dropped to zero in late February and risen above $9 million in early March—was $4.5 million and total outstandings were $198.5 million—only $1.5 million short of the maximum permitted by the I.C.C. (Ex. CW, 1405a-10a).

C. The District Court's Decision

Jurisdiction. Citing the decision of this Court in *Zeller* v. *Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied,* 414 U.S. 908 (1973), the District Court concluded that the commercial paper note sold to Franklin was a "security" for purposes of the 1934 Act because it "was not prime commercial paper at the time of purchase." 406 F. Supp. at 44 (1457a). The District Court based § 12(2) jurisdiction not on any action taken in connection with the transaction itself but, alternatively, upon one of two separate mailings after the transaction was completed.

Liability. Because the court's findings on liability are less than lucid, it is first necessary to state what the court did not find. There is no finding of any *misrepresentation* actionable under § 10(b) or Rule 10b-5; there is no finding of an *omission* actionable under § 12(2); and there is no finding that Goldman, Sachs acted with an intent to deceive, manipulate or defraud.

The court focused almost exclusively upon the meetings between Goldman, Sachs and Penn Central immediately after the announcment of Penn Central's year-end losses and the subjects discussed in those meetings. In particular, the February 9 return of inventory paper to Penn Central and "the surrounding circumstances involved in the buy-back" apparently formed virtually the sole basis for the trial court's conclusion that Goldman, Sachs "did not have faith in this paper any more and was lightening its load and reducing its exposure." On this basis the court concluded that the $10 million inventory reduction was material.

Goldman, Sachs was also held liable under § 10(b) because it failed to disclose that one investor, Brown Brothers Harriman & Co., was reported to have removed Penn Central from its approved list.

Section 12(2) liability was founded on another theory:

> "In view of the understanding between the parties as to the basis upon which the notes were being sold, which amounts to a statement of a material fact, Goldman, Sachs is also liable under Section 12(2)."

406 F. Supp. at 47 (1460a).

ARGUMENT

I.

The District Court Lacked Subject Matter Jurisdiction.

A. The Commercial Paper Involved In This Case Was Not A "Security" Under the 1934 Act

Section 3(a)(10) of the 1934 Act (15 U.S.C. § 78c(a)(10)) states unequivocally that the term "security" shall not

include "any note . . . which has a maturity at the time of issuance of not exceeding nine months . . . ." The commercial paper sold to plaintiff consisted of a note which had a maturity at issuance of slightly over three months. The words of the statute are unambiguous; the facts necessary to identify the relationship of the commercial paper held by plaintiff to the statutory language is undisputed; and the applicability of the clear words of the statute should, therefore, be self-evident.

The Supreme Court has stated: "The starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 756 (1975) (Powell, J., concurring), quoted with approval in *Ernst & Ernst* v. *Hochfelder,* 96 S. Ct. 1375, 1383 (1976). *And see Jones* v. *Alfred H. Mayer Co.,* 392 U.S. 409, 420 (1968); *FTC* v. *Bunte Brothers, Inc.,* 312 U.S. 349, 350 (1941). And where, as here, the words of the statute are clear on their face, "[n]o single argument has more weight in statutory interpretation than this." *Browder* v. *United States,* 312 U.S. 335, 338 (1941). Only when following the plain meaning of the statute produces a result which is "plainly at variance with the policy of the legislation as a whole," *Ozawa* v. *United States,* 260 U.S. 178, 194 (1922), should a court follow "that purpose rather than the literal words." *United States* v. *American Trucking Ass'n,* 310 U.S. 534 (1940). There is no ambiguity here and no Congressional intent at variance with the plain meaning of the statute. The mere incantation "remedial purpose of the securities laws" should not overcome the statute which provides that the commercial paper here is not covered by the 1934 Act.

Unfortunately, this Court has previously held that the language of § 3(a)(10) must be construed with the additional judicial gloss that a note, to come within the ex-

clusion, must also be of the "type" which would qualify for exemption under § 3(a)(3) of the 1933 Act (15 U.S.C. § 77c(a)(3)). *Zeller* v. *Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied,* 414 U.S. 908 (1973).

In *Zeller* the notes involved were demand notes which evidenced borrowings by a parent corporation from its own subsidiary. Judge Friendly, writing for the Court, concluded that a note would not be excluded under § 3(a)(10) unless "the note fits the *general notion* of 'commercial paper' reflected in" an SEC release setting forth the requirements for exemption *under the 1933 Act. Zeller,* 476 F.2d at 800 (emphasis added). The only basis for that conclusion, *id.* at 800 n.7, was the Court's reference to the legislative history of the 1934 Act and a statement that "[t]he definitions of 'issuer' and 'security' are substantially the same as those in the Securities Act of 1933." S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934).

That legislative history is the only possible support for the Court's conclusion in *Zeller* that the word "security" should be identically interpreted under both acts despite substantial difference in wording.

The main problem with reliance on the Senate Report quoted above is that it referred to a bill (S. 3420) which was *not enacted.* That bill did define security in language *identical* to the exemption language under § 3()a(3) of the 1933 Act. S. 3420, 73d Cong., 2d Sess. § 3(a)(10) (1934).

By contrast, the House Bill, H.R. 9323, which *was enacted,* defined security in precisely the language which is now embodied in § 3(a)(10) of the 1934 Act. H.R. 9323, 73d Cong., 2d Sess. § 3(a)(10) (1934).

In view of the Supreme Court's admonition that the courts should give effect to the language employed by

Congress in unambiguous statutes, this Court should recognize that *Zeller* v. *Bogue* was incorrectly decided and should be overruled.

Even were *Zeller* v. *Bogue* not overruled, however, the holding of that case compels the conclusion that Penn Central's commercial paper was not a security for purposes of the 1934 Act. The clear meaning of the *Zeller* opinion is that the 1934 Act does not apply to notes which are of "the type" normally sold in the commercial paper market, namely a highly sophisticated, professional market. Penn Central's commercial paper is precisely the kind of instrument which would fit the "general notion" of commercial paper without regard to any specific tests promulgated by the SEC to deal with a different requirement under a different act. Penn Central's commercial paper was sold by the largest commercial paper dealer to its usual professional customers; it was sold as part of the regular routine of daily trading; it was accepted by banks lending to the dealer as collateral along with all other commercial paper throughout the period that Penn Central notes were sold; and, in accordance with the practice of the market, it was sold in blocks of $100,000 or more with the average sale amounting to $1 million. None of these factors is in itself determinative, but together they are strong evidence that Penn Central's commercial paper was not on the periphery of the market but in the center.

The exclusion of generally accepted types of commercial paper from the 1934 Act is wholly in keeping with the general purpose of that Act. In 1933, Congress had passed the Securities Act which essentially provided for registration and control of distribution of and disclosure relating to new issues of securities. Commercial paper was exempt from registration under the 1933 Act so long as it fulfilled

certain requirements.* Exemption from registration did not exempt any such security from the civil liabilities of § 12(2).

The 1934 Act, on the other hand, was designed primarily to provide for fair dealing in the secondary market. Because there is no secondary market in the true sense for commercial paper there was no need to include it in the coverage of the 1934 Act. This view of the differences between the 1933 and 1934 Acts has been confirmed by the Supreme Court. *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 727-28 (1975). *See also* R. Jennings & H. Marsh, Securities Regulation, Parts I and II (3d ed. 1972).**

The error of the District Court's approach, and the grave consequences which that decision may have for the securities markets for the future, are graphically demonstrated by the facts of this case. The District Court followed the SEC pronouncement that only "prime quality" commercial

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* Significantly, there are only two requirements imposed by Congress in § 3(a)(3) for exemption of commercial paper: That the proceeds be used for a "current transaction" and that the note have a maturity at issuance of no more than nine months. Without apparent mandate from the Congress, the SEC has nevertheless attempted to impose additional tests for exemption in its Release No. 4412, 26 Fed. Reg. 9158 (Sept. 20, 1961).

** The view that Penn Central's commercial paper is not subject to actions under the 1934 Act is also supported by the SEC itself, the very agency the views of which were given such weight by the Court in *Zeller*. In his letter transmitting the Staff Report on The Financial Collapse of the Penn Central Company to Congress, Chairman William J. Casey of the SEC made that very point:

> "The antifraud provisions of the 1933 Act apply to the sale of securities exempt from regulation, although commercial paper having a maturity up to 270 days is not a security for purpose of the Exchange Act of 1934".

SEC, The Financial Collapse of the Penn Central Company viii (1972). *See also id.* 274 n.4.

paper would be exempt under the 1933 Act.* Applying that standard the District Court concluded, five years after the event, that the paper of a company which went into reorganization was not "prime quality" and hence would not have qualified for exemption from registration.** Had Penn Central not been entitled to exemption from registration as a common carrier [§3(a)(6) of the 1933 Act, 15 U.S.C. § 77c(a)(6)], every purchaser of Penn Central commercial paper would have been able to obtain automatic rescission of its purchase.

The District Court has posed an impossible position for securities dealers: In spite of the most diligent efforts of honest and experienced credit analysts to detect it, companies occasionally do go into bankruptcy without it being predicted in advance. In spite of lip service to the contrary, there is always a significant risk that a court, with the benefit of hindsight, would conclude that the commercial paper of such a company—such as here—was not of "prime quality" so as to qualify for exemption from registration. The result of such a holding would be a determination, *nunc pro tunc,* that the paper had been sold in violation of § 5 of the 1933 Act and thus the dealer was absolutely liable, as an insurer, under § 12(1) of that Act. (15 U.S.C. § 77l(1)).

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* SEC Release No. 4412, 26 Fed. Reg. 9158 (Sept. 20, 1961). There is no mention in any of the legislative material cited by the SEC in Release No. 4412 of the exemption being available only for "prime quality" paper. Indeed, the legislative history of the 1933 Act offers support only for the proposition that the SEC has *no* power or duty to regulate the quality of securities being issued. *See H.R. Rep. No. 85* (on H.R. 5480), 73d Cong., 1st Sess. 4 (1933) and *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce,* 73d Cong., 1st Sess. 53, 57-58 (1933).

** The court stated that its determination on this point was made as of the purchase date, and not as of the date of reorganization.

Goldman, Sachs submits that commercial paper dealers are entitled to rely, in conducting their business affairs, on the expectation that statutes mean what they say, and that compliance with the law should not be subject to the unpredictability that some court, some time, may impose absolute liability upon the dealer should the issuer not pay notes as they mature. Accordingly, this Court should give effect to the plain language of the 1934 Act and hold that the note here involved was not a security as defined in that Act.

B. The Mailings After The Completion Of The Sale Were Insufficient For Jurisdiction Under Section 12(2) Of The 1933 Act

In order to establish subject matter jurisdiction over the claim under § 12(2) of the 1933 Act, the commercial paper in question must have been offered or sold either (a) "by the use of any means or instruments of . . . . communications in interstate commerce. . . ." or (b) "by use of. . . . the mails."

The trial court agreed with Goldman, Sachs' position that neither the *intra*state telephone calls made to arrange Franklin's purchase nor the *inter*state telephone call made to purchase that note from Penn Central provided a basis for jurisdiction. 406 F. Supp. at 42 (1455a). The trial court concluded, however, that either of two mailings—both of which occurred after the completion of the transaction—was sufficient.

The sole relevant mailings identified by the court occurred after plaintiff's admitted agents, Chemical Bank and Savings Bank Trust Company, had transferred the necessary funds and received by hand both the note itself and a complete notation of the terms of the transaction—all without use of the mails.

The mailings relied upon by the court were the transmittal by Savings Bank Trust Company of the sales bill

to Franklin or, alternatively, the mailing by Goldman, Sachs of a "confirmation" to Franklin.*

The apparent basis upon which the court concluded that one of these mailings was sufficient was that the information contained therein was needed for the internal records of Franklin and for the auditors of the New York State Banking Department, and that accordingly the mailing by Savings Bank Trust was "foreseeable" by defendants. 406 F. Supp. at 42 (1455a).

There is absolutely no record support for the proposition that the mailing by Savings Bank Trust was foreseeable. On the contrary, the evidence in the case is consistent that transactions in the commercial paper market are completed on a same-day basis without use of the mails. Goldman, Sachs had no reason to believe that if Savings Bank Trust communicated with Franklin that it would not do so by messenger as part of the ordinary operation of the market.

In reaching its conclusion, the trial court also ignored the statutory language recognizing a cause of action only against one who *offers* or *sells* by the use of the mails. As Professor Loss has stated:

> "Since the mails or interstate facilities must be used in some manner *for the purpose of executing the fraud,* it does not suffice to show that they were used after the completion of the scheme."

III L. Loss, Securities Regulation 1525 (2d ed. 1961).**

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* Unlike practice in the equity security markets where a "confirmation" precedes final settlement of a transaction, the document mailed by Goldman, Sachs to commercial paper purchasers occurs after the sale is complete and irrevocable. In addition, it contains no significant information not shown on the "sales bill" delivered with the note itself by hand.

** Professor Loss of course acknowledges that there is no inalterable rule that a subsequent mailing can *never* form the basis for jurisdiction. VI L. Loss, Securities Regulation 3750 (1969 Supp.). This does not mean, however, that the general rule that the mailing must be related to the alleged "scheme" is abandoned or overruled.

The trial court relied in large part on *United States* v. *Cashin,* 281 F.2d 669 (2d Cir. 1960), for the proposition that mailings divorced in time from the transaction may form the basis for jurisdiction. The court below failed to note, however, that the issue in *Cashin* was whether venue was appropriate in the district in which the principal fraudulent acts were alleged to have occurred but in which no mailing had occurred. The dictum on the relationship between mailing and jurisdiction is not the delineation of a precise test of the limits of jurisdiction, but rather a passing argument made to illustrate the venue problem there under discussion.

In sum, when an entire market operates by the personal delivery of notes and documents containing a complete record of the transaction, and where funds are almost invariably transferred between money market centers by messenger, it is irrelevant that after the transaction is complete and on no particular time schedule the plaintiff receives a mailed record of information that had already been in the hands of its agents and which was known to the principal. The maintenance of such records received by mail is utterly remote from the statutory requirement that the *offer* or *sale* be by use of the mails.

II.

There Was No Finding of *Scienter* Sufficient To Meet The Standard Enunciated In *Ernst & Ernst* v. *Hochfelder*.

When Penn Central's 1969 operating results were announced in February 1970, Wilson used that information to press his momentary advantage to obtain from Penn Central agreement to reduce its dependence on Goldman, Sachs' inventory. Wilson's testimony was clear and uncontradicted that the two events—year-end results and reduction of inventory—were not coincidental; one was used to effect the other.

Unfortunately, viewed with hindsight after the collapse of the railroad some purchasers, including plaintiff, have argued that the reduction of inventory resulted from Goldman, Sachs' desire to "bail out" of Penn Central in the expectation that the company was going into bankruptcy. Plaintiff has done so by characterizing Levy and Wilson as Machiavellian (but necessarily stupid) investment bankers. As painted, they were sufficiently frightened as to reduce Goldman, Sachs' position by $10 million but at the same time were sufficiently stupid as to continue to hold $5 million of Penn Central paper in inventory and later even to allow inventory to reach $9 million continuing to sell the paper in order to curry favor with and obtain the "lucrative" other business of this future bankrupt. By this hypothesis they were also apparently sufficiently stupid to sell the commercial paper of the predicted bankrupt to Goldman, Sachs' best customers and principal commercial bankers, upon whose continued business and confidence Goldman, Sachs depended for its very existence.

It appears, however, that Judge Metzner did *not* accept the plaintiff's characterization of the inventory reduction.

Had it done so, the District Court's rejection of proffered evidence on the very issue of Goldman, Sachs' "good faith" would clearly have constituted reversible error, as we discuss in Point IIC *infra.*

Proceeding on the assumption that the District Court's rulings and findings should be interpreted so as to be internally consistent, appellants submit that what Judge Metzner found was the following: Goldman, Sachs continued to believe that plaintiff was creditworthy but was not so euphoric about the future marketability of Penn Central's notes that it was willing to take the market risk *without limitation*; rather, Goldman, Sachs was being cautious in imposing a guideline limit on its exposure with Penn Central paper.

Such a finding is consistent with a good faith belief in the creditworthiness of Penn Central, as demonstrated on this trial record. As George Doty testified, most major banks which lent money to Goldman, Sachs to finance its inventory placed limits on the amount of paper of an issuer they would accept as collateral. Obviously those banks had no reason to doubt the credit of those issuers or they would have rejected the paper entirely. Their limitations on what they would hold overnight were merely prudent banking practices. (Doty, Tr. 568a). Similarly, Mr. Bock, the President of Franklin Savings Bank, made it clear that there might be varying degrees of quality between companies, all of which are creditworthy. (Bock, Tr. 312a).*

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* Mr. John J. Sullivan, a Senior Vice President of Manufacturers Hanover Trust Company and responsible for the loans to Penn Central by that bank, testified that banks do limit purchases of commercial paper for companies in varying maximum amounts. (Sullivan, Tr. 883a-85a; Ex. FF, 1430a). Since the bank still approved the purchase of such paper, the limitations obviously did not imply that the companies in question were not creditworthy.

Goldman, Sachs itself had varying limits on the inventory of specific issuers in the fall of 1969, without there being any claim that those proposed limitations reflected a lack of good faith belief that the companies were creditworthy (Van Cleave, Tr. 430a; Ex. BM, 1390a).

The above inference as to the mental state of Wilson and Levy in reducing Penn Central's inventory is, we submit, the one accepted by the District Court. And although we do not believe it to be a proper conclusion based upon the trial record (*see* Point III *infra*), it is internally consistent and as shown hereafter comports with the position of the court adopted at trial. So interpreted, however, the conclusion does not constitute a finding of a mental state of sufficient culpability to impose liability under the securities laws as recently interpreted by the Supreme Court.

In *Ernst & Ernst* v. *Hochfelder*, 96 S. Ct. 1375 (1976), decided after the trial court's decision in *Franklin,* the Supreme Court for the first time considered fully the degree of culpability required for private damage liability under § 10(b) of the 1934 Act. The Court concluded that an "intent to deceive, manipulate, or defraud" is an essential element of liability in such an action. *Id.* at 1381. As shown hereafter, it is apparent from the context of the opinion and the conduct of the trial that the court below did not consider it necessary to find and did not find this requisite element of *scienter*.

A. The Court's Analysis of the Element of a Cause of Action Under Section 10(b) Makes No Reference to *Scienter*

The trial court began its analysis by determining that certain undisclosed facts were material as a matter of law and that hence Goldman, Sachs was under a duty to dis-

close them.* The court proceeded next to establish causation as a matter of law,** and then to cite authority for the proposition that in a nondisclosure case plaintiff need not prove reliance.*** After this analysis, and no more, the court reached its conclusion:

> "Having decided to sell the notes without disclosing these material facts, Goldman, Sachs is liable to the plaintiff for violation of Section 10(b)."

406 F. Supp. at 47 (1460a).

Nowhere does the trial court mention—in words or substance—deceit, manipulation or fraud, the concepts required by *Ernst & Ernst*. Nor does it mention "*scienter*," "reckless disregard," "guilty knowledge," or "knowing use," which were the enunciated standards of *scienter* in this Circuit before the Supreme Court decision. *See, e.g., Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971).

Because the court considered the other elements of the § 10(b) claim so methodically without once mentioning

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* The District Court relied on *List* v. *Fashion Park,* Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965), for its views on materiality, and on *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir.), *cert. denied,* 394 U.S. 976 (1969), for its conclusion on a duty to disclose. Neither case at the portion cited by the court contains any discussion of *scienter*.

** *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 154 (1972), was cited on causation. Again, no discussion of *scienter* appears in the part of the opinion referred to by the court. On the facts of that case, moreover, it was plain that the defendants acted with an intent to deceive or defraud plaintiffs.

*** The court's authority was *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath,* 516 F.2d 811 (2d Cir. 1975), and *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). In *Competitive Associates*, this Court reversed a grant of summary judgment, dealing only with the reliance and "in connection with" elements of a Rule 10b-5 claim. In *Chasins,* liability was imposed without any finding of an intent to deceive, manipulate or defraud and accordingly, there is serious question of *Chasins'* continued vitality.

scienter or making reference to the concept, the only logical inference is that it meant to impose liability for negligence or for some lesser form of culpability.

B. Other Portions of the Opinion Below Corroborate That The Trial Court Did Not Conclude That Goldman, Sachs Acted With An Intent To Deceive Or Defraud

After having found a nondisclosed fact material the trial court observed:

> "I understand the reluctance of Goldman, Sachs possibly to be the cause of such calamity to our economic structure."

406 F. Supp. at 46 (1459a). The calamity referred to was the collapse of Penn Central and the disruption of this nation's money markets. Surely, the court's finding on this score negatives any argument that Goldman, Sachs acted for the purpose of deceiving or defrauding. Even if it be conceded, which it is not, that there was any duty of disclosure in the circumstances of this case, there can be no doubt that by the court's own theory Goldman, Sachs acted with the utmost good faith in resolving a difficult dilemma.

In this regard it should be borne in mind that Goldman, Sachs did *not* decide that it would no longer carry any Penn Central commercial paper in inventory—and the court so recognized. The court only found that Goldman, Sachs was "lightening its load and reducing its exposure." At the time of the Franklin purchase Goldman, Sachs still had in inventory Penn Central commercial paper worth many times the amount bought by Franklin. Even assuming—which we dispute—that the inventory reduction *was* made for the purpose of limiting exposure, that fact does not show intent to deceive, manipulate or defraud. Any lending institution has credit limits for its customers, and

even assuming that Goldman, Sachs' $5 million limit on the size of inventory was a recognition that after the 1969 losses there was some additional risk involved in Penn Central, that hardly shows a belief that Penn Central was going bankrupt.

The Court's own language thus belies the notion that it found fraud. All it found—at most—was a caution consistent with a continued belief that the company would pay its debts—and a course of action inconsistent with a finding of fraud, deceit or manipulation.

C. Evidentiary Rulings At Trial Support The Interpretation That The Trial Court Did Not Treat This Case As One Involving The Issue of *Scienter*

Because the issue of inventory reduction seemed to bear upon the question of Goldman, Sachs' belief in Penn Central, we offered evidence at trial regarding two incidents after Franklin's purchase showing the continued good faith belief of Goldman, Sachs in Penn Central. Both were rejected by the trial court and that rejection was a serious evidentiary error independently requiring reversal. The ruling, however, is most significant in that it corroborates the view that good faith as such was never an issue seriously considered by the court below.

At trial, Goldman, Sachs sought to introduce evidence that Gustave L. Levy, senior partner of Goldman, Sachs, was trustee with sole discretion to buy and sell common stock held in a "blind trust" for a close personal friend. That trust consisted in part of approximately 180,000 shares of Penn Central common stock worth over $10 million. The rejected evidence would have shown that notwithstanding Levy's personal knowledge of and participation in various conversations with Penn Central officials, he sold all the stock in the blind trust except Penn Central because

he believed Penn Central's stock was priced too low and would rise with the market as the economy improved. The stock was held in the trust until after the reorganization petition was filed and was then sold at a loss of many millions of dollars.

As we argued to the court during trial, Levy's decision to hold the Penn Central common stock not only in February, but in April, May and June was, especially in view of the close personal relationship between himself and the beneficiary, "a badge of innocent good faith." (Tr. 810a). When that argument was made, however, Judge Metzner responded, "*I don't need it for this trial. Objection sustained.*" (*Id.* (emphasis added)).

The court's statement that evidence of good faith was not necessary can only have been based upon its conclusion that good faith, as opposed to a technical violation of the securities laws, was not an issue in the case.

Goldman, Sachs' offer of proof regarding another mark of good faith met a similar fate during the course of Levy's direct examination. Goldman, Sachs offered to prove that as late as May 27, 1970—less than a month before the petition for reorganization was filed—Goldman, Sachs purchased as principal a 70,000-share block of Penn Central common stock worth $1,250,000 (Exs. CG id., 1397a and CH id., 1401a). Goldman, Sachs kept much of that stock in its inventory overnight, thus putting at risk its own money months after the announcement which had allegedly caused the reduction in inventory of commercial paper. (*See* Offer of Proof, Tr. 813a-14a). This evidence certainly demonstrates Goldman, Sachs' continued belief in Penn Central on May 27, and *a fortiori* shows its belief at an earlier date when far less adverse news was either public or known to Goldman, Sachs. The exclusion of this evidence

by the trial court further truncated Goldman, Sachs' efforts to present fully and fairly its side of the "good faith" issue in this case, and is inconsistent with any interpretation of the opinion below except that it contains no finding on this issue.

Evidence on both these points was received in another Penn Central commercial paper trial, *Alton Box Board Co.* v. *Goldman, Sachs & Co.*, 71 C. 185(3) (E.D. Mo., filed June 10, 1976) (Wangelin, J.), where the question of good faith was faced directly. Based on a record otherwise similar to *Franklin* on the inventory reduction issue, that court concluded:

> "The recent decision of the Supreme Court in Ernst & Ernst v. Hochfelder, 44 U.S.L.W. 4451 (Mar. 30, 1976) makes it clear that for an aggrieved party to recover under § 10(b) or Rule 10b-5 that 'scienter' must be proved on the part of the defendant.
>
> "As stated in the findings of fact above, the Court after hearing the evidence finds that there was no action undertaken by the defendant Goldman, Sachs to deceive, manipulate or defraud the plaintiff."

It is submitted that the *Franklin* court did not face this issue, and made no finding upon it either for or against defendant. Accordingly, plaintiff's case fails for want of a finding of what the Supreme Court has held to be an essential element of a cause of action under § 10(b) and Rule 10b-5.

III.

Any Inference By The Trial Court That Goldman, Sachs Had Lacked Faith In The Creditworthiness Of Penn Central Would Be Clearly Erroneous.

Apart from the question of whether it constitutes *scienter,* the finding of "lost faith" is in any event grounded upon factual predicates that are without record support and are indeed contradicted by unchallenged evidence.

A. The Critical Finding That The Penn Central Inventory Return Was Unique Is Clearly Erroneous

A single finding of fact is the linchpin of the court's rejection of Goldman, Sachs' explanation of the context in which Penn Central inventory was reduced:

> "[I]t appears that only the inventory of Penn Central paper was reduced by asking the issuer to buy back. *No other inventories were reduced by Goldman, Sachs in this manner.*"

406 F. Supp. at 45 (1458a) (emphasis added).

The uncontradicted evidence proves precisely the opposite.

This issue was raised by counsel for plaintiff during cross-examination of George Van Cleave:

> "Q. Did you ever return commercial paper to any other issuers because you wished to reduce your inventory of that particular issuer?
> A. Yes."

(Van Cleave, Tr. 513a). Van Cleave was then confronted with prior deposition testimony in which he had answered a nearly identical question by saying, "Not that I can recall." (Van Cleave, Tr. 514a). Van Cleave explained

why he recalled at trial something that he had not recalled during his deposition:

> "That was my recollection at the time of the deposition, *but after reviewing our files,* I found that we *had* returned other issuers."

(*Id.* (emphasis added)). Upon receiving this response, counsel for plaintiff abandoned his line of questioning without asking what files were meant or what other companies were involved. On the basis of this cross-examination testimony, however, the matter was briefly pursued on redirect examination:

> "Q. I show you Defendants Exhibits EV [1411a] and EW [1412a] marked for identification and ask you if those two memoranda were among documents that you came upon in the course of that review [of files for the purposes of determining whether other buy-backs from inventory had occurred]?
> A. Yes.
>
> Mr. Piel: Your Honor has previously excluded these based on Mr. Stitt's challenge to Mr. Van Cleave's testimony. I respectfully re-offer them.
> Mr. Stitt: Your Honor, I [will] not press any objection."

(Tr. 551a-52a).

Like Van Cleave's testimony, these blue sheet exhibits are uncontradicted and unchallenged evidence that there were indeed other instances in which inventory was returned to an issuer. Moreover, in reaching its conclusion that the February inventory reduction in Penn Central commercial paper was unprecedented, the court also ignored the fact that there had been an earlier and larger return of Penn Central inventory in December 1969. (Lepley, Tr. 931a; Van Cleave, Tr. 457a).

Because Van Cleave's testimony and the documentary evidence that there were other instances of returns to issuers for purposes of reducing inventory was uncontradicted and unchallenged, no further evidence was offered on this point. But other evidence is available and would be offered at a new trial, as we submitted by offer of proof in our post-trial motion.

If he had been asked, Wilson would have explained that during the tight money market of 1968, 1969 and 1970 Goldman, Sachs had many times returned commercial paper to issuers.

This evidence is not hypothetical but was offered and received in the related commercial paper case of *University Hill Foundation* v. *Goldman, Sachs & Co.*, 71 Civ. 1166 (MEL) (S.D.N.Y.).* It could have been offered at trial here but was deemed duplicative because the only record evidence supported Goldman, Sachs' position and there was *no* evidence that the events of February 9 were unique.

B. The Other Findings By Which The Trial Court Sought To Underpin Its Conclusion Are Insufficient To Establish That Goldman, Sachs Had Lost Faith In Penn Central

The linchpin of the court's rejection of Goldman, Sachs' arguments having been removed, the remaining matters discussed by the court in support of its conclusion can be seen for what they are—make-weights.

Although an evaluation of such evidence would not ordinarily be a matter for this Court, it is important here because the major premise—that the Penn Central buyback was unique—is clearly erroneous. The Court must there-

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* The testimony of Wilson in *University Hill* appears at 1493a-1502a, and the Exhibits showing returns to other companies appear at 1504a-05a and 1507a-09a respectively.

fore determine whether these peripheral points standing alone or in combination are a sufficient basis for affirmance. They are not.

1. *The rapidity with which inventory was reduced*

The court below dismissed Goldman, Sachs' explanation for the reduction of inventory in part by emphasizing that it was done too hurriedly, "on the following Monday, without any experience as to whether the paper could be sold or not." 406 F. Supp. at 45 (1458a). The District Court misperceived the evidence at trial. What Wilson was saying to O'Herron was that the announcement of Penn Central's year-end results were going to cause a run-off which would in turn result in a further build-up in inventory. It would not have made good business sense to have procrastinated on that request until an unmanageable inventory accumulated; and in any event, Wilson was seizing the opportunity presented by the prospect of a runoff to achieve a long sought goal:

> "I was anticipating that this news that was in the press was going to bring about a run-off in the outstandings of the Penn Central paper from two hundred million down either to one hundred fifty or less, and I had been—myself and through Jack Vogel and George Van Cleave for some months now had been suggesting that they set up bank lines, additional bank lines, on top of the one hundred million of unused bank lines so that they would have closer to if not 100 per cent bank line coverage. In my mind I thought we were going to see a run-off. I happened to be wrong in this instance. It didn't. The paper sold well. But I was anticipating this, and I had not been very successful in getting John O'Herron to set up these additional standby lines. So I was deciding to get a little tough with them in

> negotiating with them, and one way to do that in my mind is to say [if] there is going to be a run-off which I see coming, don't look to Goldman, Sachs to carry huge positions of your paper that's not selling. That's not the purpose of our inventory. It is costing us a lot to carry it, to mark it up, I knew those costs of carrying big positions, and I wanted him to do two things: one, to set up additional lines of credit, and also to set up these swing-lines. One way to stop this long series of negotiations was to get tougher with them, so I picked a limit, a target, five million dollars."

(Wilson, Tr. 1104a-05a).

2. *Goldman, Sachs' use of "existing insufficient lines of credit."*

The trial court also deemed it relevant that the reduction of inventory "was being financed by Penn Central out of its existing insufficient lines of credit." 406 F. Supp. at 45 (1458a). Concededly those lines were used in the inventory repurchase. In fact their entire purpose was to stop Penn Central from imposing the cost of its unsold commercial paper on Goldman, Sachs.

After Penn Central had used $10 million of its swing lines to buy back commercial paper from Goldman, Sachs, however, its usage of swing lines declined practically to zero. (Ex. BI, 1387a-89a). This means that the swing line borrowings used to buy inventory paper from Goldman, Sachs on February 9 were repaid out of the proceeds of subsequent sales. When lines were used thereafter, it was utterly unrelated to the facts surrounding the buyback in February. Indeed, the lines were activated and deactivated several times after February 9, and it was ultimately investors whose notes matured prior to June 21 who benefited from them.

3. *The speed with which Goldman, Sachs convened a meeting with Penn Central personnel in February*

Another of the "surrounding circumstances" which may have been viewed by the court as significant in assessing Goldman, Sachs' motives was the rapidity with which Goldman, Sachs acted upon hearing the news of Penn Central's 1969 year-end results:

> "The fourth quarter was supposed to show a profit and the loss shocked the people at Goldman, Sachs into immediate action. They conferred among themselves the night of February 4 and on February 5. They arranged a luncheon conference with the Penn Central people for Friday, February 6."

406 F. Supp. at 44-45 (1457a-58a).

Any inference that Goldman, Sachs' decision to convene a meeting with Penn Central personnel reflected panic ignores the evidence that such a meeting was simply a sensible precaution that any businessman might take in the circumstances. Indeed, on February 5, representatives of a number of the major national banks which had lending relationships with Penn Central also met with Bevan, O'Herron and others from Penn Central "to discuss the operations of the Penn Central past and future and to request an additional $50 million in loans to be borrowed by the Pennsylvania Company (Pennco)." (Ex. AD, 1380a). As recorded in a contemporaneous memorandum prepared by the representative from Manufacturers Hanover Trust Company, the substance of the bank meeting and the Goldman, Sachs meeting were virtually identical. Moreover, these banks and others* studied the earnings,

* (Ex. BY, 1392a).

listened to management's plans and—like Goldman, Sachs—concluded that despite the magnitude of the losses, Penn Central, with its tremendous assets, was creditworthy and a company to which they were willing to lend money. (Sullivan, Tr. 862a-75a).

4. *Other business done by Goldman, Sachs with Penn Central*

The court's off-handed statement that Goldman, Sachs "had close business, if not personal ties, to the Penn Central management which would be jeopardized in the event of collapse," 406 F. Supp. at 46 (1459a), is not only clearly erroneous but irrelevant in light of the other evidence at trial.

Exhibits PW (1436a) and PX (1437a) indicate the total Goldman, Sachs revenues, apart from commercial paper, received from Penn Central during the 1968-70 period. Exhibit PW shows that the gross commission business done with Penn Central cannot be considered significant when compared to Goldman, Sachs' major securities commission customers, including many to whom Penn Central notes which have not been repaid were sold. The total for 1968 was $17,000, for 1969, $26,000 and for 1970—including more than $6,000 of business *after* the reorganization—less than $28,000.

When Goldman, Sachs revenues derived from Penn Central are compared with the hundreds of thousands of dollars of brokerage commissions received from the Penn Central commercial paper investors (Doty, Tr. 584a-86a), it becomes ludicrous to suggest that Goldman, Sachs—by whatever standard judged, a firm of intelligent businessmen—would jeopardize those substantial relationships in

order to obtain the business of a future bankrupt.* As Mr. Doty testified, many of the investors purchasing Penn Central commercial paper were the very banks which furnished the funds with which Goldman, Sachs conducted its business, and without which Goldman, Sachs could not survive for a single day. (Doty, Tr. 569a-71a).

Coupled with the insignificance of Penn Central's other business was the unchallenged testimony of Mr. Vogel that his recommendations to discontinue an issuer for credit reasons were never overruled, even in those cases where the issuer was a long-valued client of the firm. (*See* Vogel, Tr. 711a-13a; *see also* Vogel Dep. 69-71; Levy Dep. 24, 191-92).

In short, the "other business" of Penn Central was so small when compared with the life blood business obtained from those to whom Penn Central commercial paper was sold, that those sales confirm Goldman, Sachs' good faith belief rather than show a supposed conflict of interest.

IV.

In The Circumstances Of This Case No Undisclosed Fact Was Material To This Plaintiff.

The trial court adopted as its standard of materiality the test of whether " 'a reasonable man would attach importance [to the fact] in determining his choice of action in the transaction . . . .' " 406 F. Supp. at 47 (1460a) (quoting *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.),

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* Exhibit CV is a variation of Exhibit F-93 (1365a) listing all investing entities to which Goldman, Sachs sold Penn Central commercial paper in reverse chronological order by date of last purchase. Exhibit CV shows that those entities purchasing paper in the winter and spring of 1970 were among Goldman, Sachs' best and most important customers, and included the banks upon which Goldman, Sachs depended for its borrowing to finance commercial paper and securities inventory. (Doty, Tr. 583a-88a).

cert. denied, 382 U.S. 811 (1965)). Since the trial court's decision the Supreme Court has spoken with respect to the issue of materiality in the related context of suits under § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a), regarding omissions in proxy statements. The Court there held that "an omitted fact is material if there is a *substantial likelihood* that a *reasonable* shareholder would consider it important in deciding how to vote." *TSC Industries, Inc.* v. *Northway, Inc.,* 96 S. Ct. 2126, 2133 (1976) (emphasis added). Although that decison was directed at materiality under a different section of the 1934 Act, the logic of the opinion is equally applicable to the concept of materiality under § 10(b) of the 1934 Act and § 12(2) of the 1933 Act. Translating the Court's statement into terms useful under § 10(b) and § 12(2), an omitted fact should be deemed material only if there is a substantial likelihood that a reasonable investor would consider the fact important in deciding whether or not to purchase or sell the security in question, or in other words, that the fact would have assumed actual significance in the reasonable investor's deliberations:

> "[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having signicantly altered the 'total mix' of information made available."

96 S. Ct. at 2133 (footnote omitted).

Whether judged by the standard of *List* or *TSC,* the few omitted facts which can be identified from the trial court's opinion are not material.

Careful review of the opinion reveals only two facts held by the court to be material:

> "It is the surrounding circumstances involved in the buy-back, and the removal of Penn Central commercial paper from Brown Brothers Harriman's ap-

> proved list on February 5, which creates the problem in this case."

406 F. Supp. at 46 (1459a). The materiality of these two matters will be briefly discussed.

A. The February 9 Inventory Reduction Was Not Material

As previously shown, Goldman, Sachs' reduction in the size of its inventory of Penn Central commercial paper was done for reasons unrelated to the creditworthiness of the company. Seen in that light, it is inconceivable that an investor in the position of Mr. Bock—the man who knew about the 1969 year-end losses but asked not a single question about those results or the future prospects of Penn Central before investing $500,000 of his bank's money—would have paused for a moment over this event, so long as it was a market adjustment not done in bad faith. The materiality of the inventory reduction, then, hinges upon the question of whether or not it reflected or constituted actual fraud. Only then could it be characterized as a fact in which Bock would reasonably have been interested. As shown above, the trial court did not—and could not—find actual fraud on the facts or record in this case.

In its trial brief plaintiff relied on *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970), in support of the proposition that Goldman, Sachs' action in reducing inventory would have been of interest to Bock regardless of whether such action constituted actual fraud because Bock *might* have concluded from those facts that Goldman, Sachs' motive in continuing to sell the commercial paper was suspect. That approach, however, cannot survive the Supreme Court decisions in *Ernst & Ernst* and *TSC.* By predicating liability upon facts which merely *suggested* an improper motive, *Chasins* is inconsistent both with the conclusion of *Ernst & Ernst* that an actual intent to deceive, manipulate or defraud is necessary and with the conclusion

of *TSC* that the fact must be one which was substantially likely to affect the investment decision in question.

What is apparent from the record in this case is that Mr. Bock, although a self-proclaimed professional investor (Bock, Tr. 190a), was unaware of and unconcerned about the inventory or lack of inventory of Penn Central paper, the earnings record of Penn Central, the trend of those earnings, or almost any other fact concerning Penn Central or Goldman, Sachs. 406 F. Supp. at 46 (1459a). Because materiality must be determined "under all the circumstances" (*TSC Industries, Inc.* v. *Northway, Inc.,* 96 S. Ct. at 2133), this attitude on Bock's part bears upon the determination of materiality by identifying relevant circumstances. Bock was aware that higher yield meant higher risk and chose dealer paper because it had the highest yield. (Bock Tr. 176a-77a). What really was material to Bock was the yield on the paper, and any undisclosed fact concerning inventory would have been material to him only if it reflected an intent to deceive or defraud Franklin.

Because there is no proof of actual fraud sufficient to satisfy the standards of *Ernst & Ernst,* the inventory reduction—the only conceivable relevance of which is its possible bearing on state of mind—is also not material under *TSC*.

B. The Removal Of Penn Central From The "Approved List" Of Another Goldman, Sachs Customer Is Not Material And Evidence To That Effect Was Improperly Excluded At Trial

The only other undisclosed fact apparently found to have been material was that Brown Brothers Harriman & Company removed Penn Central from its approved list in early February of 1970. Although a Goldman, Sachs "blue sheet" (Ex. F-4, 1305a) does record that Brown Brothers temporarily removed Penn Central from its approved list, there is not a shred of evidence in the record indicating the basis for that removal or connecting it in any way to a

determination by Brown Brothers that Penn Central was not creditworthy.

Early in the trial, the court recognized the insignificance of the Brown Brothers point and instructed counsel not to pursue the issue:

> "Q. Did Goldman, Sachs disclose that information [regarding the removal of Penn Central from Brown Brothers approved list] to prospective purchasers or existing holders of Penn Central paper?
>
> The Court: What difference does that make to this lawsuit?
>
> Mr. Stitt: Because, your Honor, we contend that that would have been material information—
>
> The Court: If some purchaser of this paper from Goldman, Sachs decided not to buy it any more? Supposing the plaintiff decided not to buy any more. Was Goldman, Sachs supposed to tell everybody in the world that Franklin Savings Bank wouldn't buy Penn Central paper anymore?
>
> Mr. Stitt: I think that the decision of Brown Brothers Harriman with its history and reputation, history in railroad financing—
>
> The Court: *I disagree. Next point.*
>
> "Q. Do you know of any such disclosure, Mr. Van Cleave?
>
> Mr. Piel: Objection.
>
> The Court: *I don't know what you are going through it for. I am not going to give it any weight."*

(Tr. 542a (emphasis added)).*

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* *See* Defendants' Post-Trial Memorandum at 41. Goldman, Sachs' understanding of the court's ruling on the issue was further confirmed during summation when counsel for plaintiff again tried to raise the issue of Brown Brothers and the court interrupted saying, "I told you that I would not consider that as a factor." The court then added, "[w]hy didn't you bring Brown Brothers here to tell me why they did it?" (Tr. 1277a).

It is difficult to comprehend how a fact which the court at trial said was not to be given "any weight" can suddenly have become a fact that a reasonable man would find important. It is respectfully submitted that the trial court's reaction upon hearing the fact for the first time is itself a fair test of how a reasonable investor would react. And on that basis it is clearly not material.

Had the issue of Brown Brothers' removal of Penn Central from its approved list not been eliminated early in the trial, Goldman, Sachs would have offered answering evidence on the point. First, Brown Brothers itself had an unsecured line of credit which was available to Penn Central. On April 30, 1970—long after the 1969 results had been announced and a little more than a week after the far more significant first quarter results for 1970 were publicly available—Brown Brothers lent $2,000,000 of its own money to Penn Central under that line on an unsecured basis not legally or practically different than a commercial paper note. (Lepley, Tr. 950a-51a).*

The significance of that lending decision is summarized by the court in *Alton Box Board Co.* v. *Goldman, Sachs & Co.*, 71 C. 185(3) (E.D. Mo., filed June 10, 1970), where the issue of the attitude of another bank—part of the same lending group as Brown Brothers—was of central importance:

> "The Court is firmly of the opinion that First National Bank was well aware of the projected losses of the Penn Central during 1970, and particularly

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* The court prevented Goldman, Sachs from inquiring of Mr. Bock what effect it would have had on his judgment regarding the significance of Brown Brothers' approved list if he had known that Brown Brothers had an unsecured line of credit which it made available to Penn Central. (Tr. 298a-99a). In light of the similar hypothetical testimony Bock was permitted to give in direct examination—including testimony on this very issue (Bock, Tr. 158a)—the lack of evenhanded rulings upon a point which may have been dispositive is alone reason for reversal here.

> notes that even after the transaction upon which this lawsuit is based, First National loaned a substantial amount of money to Penn Central Transportation Company. It would be fatuous to say that a large bank such as First National would lend money to a firm that it knew was not creditworthy."*

Because it was led to believe that the Brown Brothers issue had been eliminated by the court, Goldman, Sachs also did not offer evidence on the significance of approved lists generally or on the manner in which they are compiled and used. Such evidence would have shown that companies such as Brown Brothers regularly add and remove names from such lists for reasons unrelated to creditworthiness.**

In sum, defendants' omissions of proof—done in reliance upon the trial court's ruling—combined with plaintiff's utter failure to explain the removal of Penn Central from Brown Brothers' approved list and its failure despite the trial court's suggestion to produce a witness to explain this matter, make it inappropriate for that court to have based its decision upon an inference drawn from a fact to which it said it would give "no weight."

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* That the money lent both by Brown Brothers and First National Bank-St. Louis was part of a line of credit did not affect the moral and legal right of either bank to have refused to make the loan in April if dissatisfied with the credit of the borrower. (Van Cleave, Tr. 420a; Vogel, Tr. 681a; Sullivan, Tr. 877a).

** This was also the subject of an offer of proof in the post-trial motion, which was rejected.

V.

No Express Or Implied Statement By Goldman, Sachs Was Rendered Misleading By The Omission Of Any Material Fact; Accordingly, No Liability Could Properly Be Imposed Under Section 12(2) Of The 1933 Act.

In addition to holding Goldman, Sachs liable under § 10(b) and Rule 10b-5 of the 1934 Act, the trial court concluded that Goldman, Sachs was liable under § 12(2) of the 1933 Act. The entire holding with respect to that section is contained in a one sentence paragraph:

> "In view of the understanding between the parties as to the basis upon which the notes were being sold, which amounts to a statement of a material fact, Goldman, Sachs is also liable under Section 12(2)."

406 F. Supp. 47 (1460a). By its statement the court apparently recognized that, unlike certain cases under § 10(b) and Rule 10b-5, a pure omission is not a sufficient basis for imposing liability under § 12(2), but instead a statement rendered misleading by the omission of particular facts must be identified. *Trussell* v. *United Underwriters Ltd.*, 228 F. Supp. 757, 762 (D. Colo. 1964).*

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* This Circuit has taken the same general apprach in an analysis of the parallel language in Rule 10b-5(2). *See Hafner* v. *Forest Laboratories, Inc.*, 345 F.2d 1967 (2d Cir. 1965); *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1300 (2d Cir. 1973) (en banc), citing *Wessel* v. *Buhler*, 437 F.2d 279 (9th Cir. 1971). Numerous other cases confirm the proposition that, in the ordinary course, mere silence is not actionable. *See Hill York Corp.* v. *American Int'l Franchises, Inc.*, 448 F.2d 680, 696 n.5 (5th Cir. 1971); *Murphy* v. *Cady*, 30 F. Supp. 466 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); *Phillips* v. *Reynolds & Co.*, 297 F. Supp. 736, 737 n.2 (E.D. Pa. 1969). *Accord*, III L. Loss, Securities Regulation 1702 (2d ed. 1961).

The court did not identify the "understanding" which it found amounted to a statement of fact. Its conclusion must logically refer, however, to its earlier finding that "it was understood that [Goldman, Sachs] was holding out the paper as credit-worthy and high quality." 406 F. Supp. 46-47 (1459a-60a). Once that "statement" made by Goldman, Sachs is understood for what it was—an expression of opinion—it will be seen that the statement was not rendered misleading by the omitted facts upon which the court relied.

Goldman, Sachs has acknowledged and continues to acknowledge that by selling commercial paper it implicitly conveyed to at least some investors—including Franklin—that in Goldman, Sachs' opinion, the issuers of commercial paper it sold were creditworthy as that term is used in the market. It is not true that Goldman, Sachs, expressly or by implication, told Franklin Savings Bank that commercial paper issuers generally, or Penn Central in particular, were "high quality."

The testimony most closely resembling the court's conclusion regarding "high quality" appears to be Mr. Bock's claim that he understood that he was getting "prime quality" paper and that he mentioned that fact to a commercial paper salesman at the outset of the relationship between Franklin and Goldman, Sachs. (*E.g.,* Bock, Tr. 109a). It is undisputed, however, that if that term was used at all, it was never defined or explained to Goldman, Sachs. During the course of trial, the court so held:

> "I don't understand what this is all about, Mr. Stitt. This witness says he never defined for Mr. Bruno [a Goldman, Sachs salesman] what he meant by prime quality. . . . What he had in his mind, which he never told anybody, has no impact on the defendant. Unless you are going to show that there is some es-

tablished custom in the industry that prime quality is of a higher, I don't know what you would call it, quality than prime rated.

* * *

The testimony has been abundant as to what this witness had in his mind, but *I find it has no bearing on the issue* because he admits he never told Mr. Bruno what he meant by prime quality, assuming that's what he told Mr. Bruno . . . ."

(Tr. 314a-15a (emphasis added)). The trial court's conclusion at the time it heard the testimony vividly establishes the insignificance of the notion of "prime quality." The court's subsequent transmutation of that term into "high quality" in its opinion is totally unsupported.*

As indicated, Goldman, Sachs recognized from the outset of the case that the offer and sale of commercial paper by the oldest and largest dealer in the marketplace does carry with it the implied statement of Goldman, Sachs' opinion, namely that the issuer of paper being offered is creditworthy. The statement of opinion, however, is actionable only if recklessly or dishonestly held. The courts have often stated that a dealer is not an insurer against loss, *see, e.g., List* v. *Fashion Park, Inc.,* 340 F.2d 457, 463 (2d Cir. 1965), and the mere fact that an opinion proves with the passage of time to have been inaccurate is not a basis for recovery. Thus, for example, in *Myzel* v. *Fields,* 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968), the court affirmed a judgment in a case where the following

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* In this regard it is also noteworthy that the court's opinion is worded in the passive tense:

> "It was understood that [Goldman, Sachs] was holding out the paper as creditworthy and high quality."

The passive conveniently allows the opinion to avoid identifying the persons by whom the statement was understood—perhaps plaintiff, but not Goldman, Sachs.

jury charge was given with respect to the matter of opinions:

> "'No *recovery* may be based on an expression of opinion by the defendants *unless* the opinion was *completely unfounded and reckless*, or unless it was *deliberately intended to be misleading*. The plaintiffs can also recover if you believe that the defendants gave any *definite opinions or assurances* about the future which they *thought were false* when they made them.'"

386 F.2d 718, 734 n.8 (quoting trial court's instructions to jury) (emphasis added).

Notwithstanding the logical necessity that Goldman, Sachs' "statement" be recognized as an opinion and not a guarantee against loss, the trial court did not examine the question of whether the opinion of Goldman, Sachs that Penn Central was creditworthy was reasonably held. Goldman, Sachs presented extensive testimony—much of it by Goldman, Sachs' witnesses clearly qualified as experts—in support of the position that its credit analysis of Penn Central was reasonable when made. Goldman, Sachs also briefed this matter extensively both before and after trial. Plaintiff by contrast produced no witness and advanced no significant argument regarding the reasonableness of Goldman, Sachs' credit decision. It is perhaps for that reason that the trial court avoided any decision on the question of whether in its view Goldman, Sachs' opinion was reasonable.

Because it made no such finding the trial court relied in its analysis under § 12(2) upon the same operative facts that caused it to find liability under § 10(b). A close reading of the opinion reveals that the court held under § 12(2) only that the two identified omitted facts (the removal of Penn Central from Brown Brothers Harriman's ap-

proved list and the inventory reduction) rendered misleading the implied statement of Goldman, Sachs' opinion of creditworthiness.

The non-materiality of Brown Brothers Harriman's removal of Penn Central from its approved list has already been considered in IVB *supra*, and it is submitted that by any standard—including that adopted by the court at trial —that issue did not and could not affect the honesty of Goldman, Sachs' opinion.

The question of Goldman, Sachs' inventory reduction has also been considered at length, and, as has been shown, the record evidence does not show—and the court did not find —that fraud, deception or manipulation was involved. A question may arise, however, as to whether the absence of a requirement of *scienter* under § 12(2) justifies imposition of liability even without such a finding.

It is common learning that § 12(2) imposes a "negligence" standard upon the seller of securities, and that a wronged purchaser need not prove an intent to defraud. *See, e.g.*, *Hill York Corp.* v. *American Int'l Franchises, Inc.*, 448 F.2d 680, 695 (5th Cir. 1971).

In ordinary circumstances that difference may be significant in that it allows recovery against one who carelessly fails to uncover material facts. In this case, however, the distinction between § 12(2) and § 10(b) is not significant because the critical question is whether or not Goldman, Sachs' reduction in inventory reflected a fraudulent state of mind. If it did, liability should clearly be imposed under both sections; and if it did not, no liability should be imposed under either. The concept of *negligently* failing to discover or convey one's own fraudulent mental state is simply meaningless: either the inventory reduction was part of a scheme to defraud—in which case the fact is

material and Goldman, Sachs is liable under both sections —or the reduction in inventory was, as we have argued, a mere business decision based on factors not amounting to fraud. If the latter, the fact that § 12(2) imposes a negligence standard makes no difference because the statement—here the opinion of honest belief—was still true.

CONCLUSION

For the foregoing reasons, the judgment of the District Court should be reversed or, in the alternative, the judgment should be vacated and the case remanded for a new trial.

Dated: June 28, 1976

Respectfully submitted,

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76-7178

United States Court of Appeals
FOR THE SECOND CIRCUIT

B
P/S

Docket No. 76-7178

FRANKLIN SAVINGS BANK OF NEW YORK,
Plaintiff-Appellee,

—against—

GUSTAVE L. LEVY, *et al.*,
Defendants-Appellants.

STATUTORY PAMPHLET

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Sections 3(a)(3) and 3(a)(6) of the Securities Act of 1933, 15 U.S.C. §§ 77c(a)(3) and (6):

Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

* * *

(3) Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited;

* * *

(6) Any security issued by a common or contract carrier, the issuance of which is subject to the provisions of section 20a of Title 49;

* * *

Section 12(2) of the Securities Act of 1933, 15, U.S.C. § 77l(2):

Any person who—

* * *

> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10):

When used in this chapter, unless the context otherwise requires—

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

* * *

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SEC Rule 10b-5, 17 C.F.R. § 240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(1) To employ any device, scheme, or artifice to defraud,

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.